Initial Statement of Reasons for

Proposed Amendments to California Code of Regulations,

Title 18, Section 1502, *Computers, Programs, and Data Processing*

SPECIFIC PURPOSE, PROBLEMS INTENDED TO BE ADDRESSED, NECESSITY, AND ANTICIPATED BENEFITS

Current Law

Subdivision (f)(1) of California Code of Regulations, title 18, section (Regulation) 1502, *Computers, Programs, and Data Processing*, prescribes the application of sales and use tax to the sale or lease of prewritten programs and maintenance contracts sold in connection with the sale or lease of prewritten programs. Regulation 1502, subdivision (f)(1) explains that prewritten programs may be recorded on tangible storage media or coding sheets and provides that tax applies to the sale or lease of storage media or coding sheets on which or into which prewritten programs have been recorded, coded, or punched. However, Regulation 1502, subdivision (f)(1)(D) provides that the sale or lease of a prewritten program is not a taxable transaction if the program is "transferred [in an electronic download transaction] by remote telecommunications from the seller's place of business, to or through the purchaser's computer and the purchaser does not obtain possession of any tangible personal property, such as storage media, in the transaction." Subdivision (f)(1)(D) also provides that the sale of a prewritten program is not a taxable transaction if the program is "installed by the seller on the customer's computer [in a load-and-leave transaction] except when the seller transfers title to or possession of storage media or the installation of the program is a part of the sale of the computer."

The first paragraph in Regulation 1502, subdivision (f)(1)(C), describes the characteristics of maintenance contracts. It currently provides that:

> Maintenance contracts sold in connection with the sale or lease of prewritten computer programs generally provide that the purchaser will be entitled to receive, during the contract period, storage media on which prewritten program improvements or error corrections have been recorded. The maintenance contract also may provide that the purchaser will be entitled to receive, during the contract period, telephone or on-site consultation services.

Prior to January 1, 2003, all of the charges for optional maintenance contracts were generally taxable because Regulation 1502, subdivision (f)(1)(C) provided that "If the purchase of the maintenance contract is optional with the purchaser, but the purchaser does not have the option to purchase the consultation services in addition to the sale or lease of storage media containing program improvements or error corrections, then the charges for the consultation services are taxable as part of the sale or lease of the storage media." However, in 2002, the State Board of Equalization (Board) amended Regulation 1502, subdivision (f)(1)(C) to recognize that optional maintenance contracts often involve both the sale or lease of taxable tangible personal property

and the provision of nontaxable services, and establish the bright-line rule that only 50 percent of the lump-sum charge for an optional maintenance contract is for the sale of taxable tangible personal property for reporting periods beginning on or after January 1, 2003. The last two paragraphs in Regulation 1502, subdivision (f)(1)(C), currently provide as follows:

> For reporting periods commencing on or after January 1, 2003, if the purchase of the maintenance contract is optional with the purchaser, that is, if the purchaser may purchase the prewritten software without also purchasing the maintenance contract, and there is a single lump sum charge for the maintenance contract, 50 percent of the lump sum charge for the maintenance contract is for the sale of tangible personal property and tax applies to that amount; the remaining 50 percent of the lump sum charge is nontaxable charges for repair.
>
> If no tangible personal property whatsoever is transferred to the customer during the period of the maintenance contract, tax does not apply to any portion of the charge. Tax does not apply to a separately stated charge for consultation services if the purchaser is not required to purchase those services in order to purchase or lease any tangible personal property, such as a prewritten computer program or a maintenance contract.

Proposed Amendments

Need for Clarification

Board staff thought that some retailers were currently selling or leasing prewritten programs via electronic download and/or load-and-leave transactions and also offering to separately sell their customers optional maintenance contracts that entitle the customers to receive a backup copy of the same or similar prewritten programs recorded on tangible storage media, which the customers could use to restore lost or corrupted data. Board staff thought that, when a customer purchased a prewritten program and maintenance contract in this type of paired transaction, there may be some confusion as to:

- Whether the retailer's charge for the prewritten program that was sold or leased in the electronic download or load-and-leave transaction is a nontaxable charge under Regulation 1502, subdivision (f)(1)(D); and
- Whether the maintenance contract can be properly characterized as "optional" so that only 50 percent of the lump-sum charge for the maintenance contract is taxable under Regulation 1502, subdivision (f)(1)(C).

Board staff thought that part of the confusion was due to the first paragraph of Regulation 1502, subdivision (f)(1)(C), which specifies that maintenance contracts generally provide that the purchaser is entitled to receive storage media upon which "improvements" and "error corrections" are recorded, and the fact that it is not entirely clear whether a backup copy of a prewritten program is included in the references to "improvements" and "error corrections." Board staff also thought that part of the confusion was due to the fact that there are currently no provisions in Regulation 1502, subdivision (f)(1)(C) or (D) that expressly indicate that

nontaxable electronic download and load-and-leave transactions may be appropriately paired with optional maintenance contracts that entitle customers to receive tangible storage media and are subject to tax at 50 percent of the lump-sum charge.

As a result, Board staff raised the issue during the Board's January 15, 2013, Business Taxes Committee meeting. And, recommended that the Board authorize staff to conduct one focused interested parties meeting regarding potential amendments to Regulation 1502 to expressly clarify that when a consumer purchases a prewritten program in an electronic download or load-and-leave transaction that does not include the transfer of tangible storage media, and also purchases a separate optional maintenance contract that includes the transfer of a backup copy of the same or similar prewritten program recorded on tangible storage media, then:

- Tax does not apply to the charge for the prewritten program itself; and
- Tax applies to 50 percent of the lump-sum charge for the optional maintenance contract.

At the conclusion of the January 15, 2013, Business Taxes Committee meeting, the Board unanimously voted to approve staff's recommendation.

Interested Parties Process

In preparation for the interested parties meeting, Board staff reviewed the 2002 amendments adding the second and third paragraphs to Regulation 1502, subdivision (f)(1)(C), which are quoted above, and staff determined that the 2002 amendments were intended to create a bright-line rule that only 50 percent of the lump-sum charge for an optional maintenance contract that entitles the purchase to receive tangible personal property is taxable. In addition, staff determined that the language in the first paragraph of Regulation 1502, subdivision (f)(1)(C), was intended to generally describe maintenance contracts, including maintenance contracts that entitle purchases to receive tangible personal property, such as storage media. Staff did not see any indication that the language in the first paragraph of Regulation 1502, subdivision (f)(1)(C) was intended to limit the types of tangible personal property that can be transferred under maintenance contracts, including optional maintenance contracts.

Further, staff found that when the Board adopted the 2002 amendments to Regulation 1502, subdivision (f)(1)(C), the Board intended for optional maintenance contracts that entitle customers to receive tangible personal property to be taxed the same way. Staff did not see any indication that the Board intended for some optional maintenance contacts sold in connection with the sale or lease of a prewritten program to be taxed differently merely because they provide that the customer is entitled to receive storage media containing a backup copy of a prewritten program, so that the purchaser may use the backup copy to restore lost or corrupted data from the original prewritten program to which the maintenance contract relates, as opposed to other tangible personal property.

Furthermore, staff did not find any indication that when the Board adopted the 2002 amendments to Regulation 1502, subdivision (f)(1)(C), the Board intend to limit the application of subdivision (f)(1)(C)'s provisions to optional maintenance contracts sold in connection with taxable sales and leases of prewritten programs, or otherwise prohibit the provisions from applying to optional

maintenance contracts sold in connection with nontaxable electronic download and load-and-leave transactions described in subdivision (f)(1)(D). Also, staff could not find any reason why subdivision (f)(1)(C)'s provisions should be limited to optional maintenance contracts sold in connection with taxable purchases of prewritten programs recorded on tangible storage media, at this time.

As a result, Board staff drafted amendments to Regulation 1502, subdivision (f)(1)(C) to clarify that when a maintenance contract, including an optional maintenance contract, is sold in connection with the sale or lease of a prewritten program, the maintenance contract may include a backup copy of the same or similar prewritten program recorded on tangible storage media, so that the purchaser may use the backup copy to restore lost or corrupted data. Board staff also drafted amendments to Regulation 1502, subdivision (f)(1)(D) to clarify that subdivision (f)(1)(C) applies to optional maintenance contracts sold in connection with nontaxable transactions described in subdivision (f)(1)(D). Then, staff distributed the draft amendments to the interested parties and discussed the draft amendments at an interested parties meeting on March 6, 2013.

During the March 6, 2013, interested parties meeting, Mr. Mark Nebergall, President of the Software Finance & Tax Executives Council, expressed his understanding that backup copies of prewritten programs are simply used to restore prewritten programs, rather than lost or corrupted data, as stated in staff's draft amendments to Regulation 1502, subdivision (f)(1)(C), and recommended that the amendments to subdivision (f)(1)(C) be revised accordingly. Mr. Nebergall also expressed his understanding that it is not currently a common business practice for software retailers to provide a backup copy of a prewritten program to their customers as part of an optional maintenance contract.

During the March 6, 2013, interested parties meeting, Board staff agreed to consider Mr. Nebergall's recommendation to revise the draft amendments to subdivision (f)(1)(C) to specify that backup copies of prewritten programs may be used to restore prewritten programs, rather than lost or corrupted data. Staff also explained that the amendments to Regulation 1502 are intended to eliminate confusion regarding the treatment of backup copies of prewritten programs under existing law, and that the clarification may lead to changes in software retailers' current business practices.

In addition, Board staff received a March 22, 2013, letter from Mr. Nebergall, which he sent on behalf of the California business community. In the letter, Mr. Nebergall reiterated his comments from the March 6, 2013, interested parties meeting, and indicated that the California business community does not oppose the draft amendments to Regulation 1502, subdivision (f)(1)(C) and (D) with the revision he previously requested.

August 13, 2013, Business Taxes Committee Meeting

Board staff subsequently prepared Formal Issue Paper 13-007 and distributed it to the Board Members on August 2, 2013, for consideration at the Board's August 13, 2013, Business Taxes Committee meeting. The formal issue paper recommended that the Board propose to adopt staff's draft amendments to Regulation 1502, subdivision (f)(1)(C) with the change requested by

Mr. Nebergall, and also propose to adopt staff's draft amendments to Regulation 1502, subdivision (f)(1)(D) without any changes. At the conclusion of the August 13, 2013, Business Taxes Committee meeting, the Board Members unanimously voted to propose the amendments to Regulation 1502, subdivision (f)(1)(C) and (D) recommended in the formal issue paper. The Board determined that the proposed amendments to Regulation 1502 are reasonably necessary for the specific purpose of eliminating any problems software retailers, software consumers, or Board staff may have understanding that:

- Tax applies to 50 percent of the lump-sum charge for optional maintenance contracts that entitle customers to receive a backup copy of a prewritten program recorded on tangible storage media; and
- Nontaxable electronic download and load-and-leave transactions may be appropriately paired with separate optional maintenance contracts that entitle customers to receive tangible storage media and are subject to tax at 50 percent of the lump-sum charge.

The Board anticipates that the proposed amendments to Regulation 1502 will provide the following benefits:

- Eliminate confusion by clarifying to the public and staff that a backup copy of a prewritten program recorded on tangible storage media may be included in a maintenance contract sold in connection with the sale or lease of the same prewritten program;
- Provide clarification to the public and staff that taxable optional maintenance contracts are still taxed the same, even if they include a backup copy of a prewritten program recorded on tangible storage media; and
- Maintain the bright-line rule that 50 percent of the lump-sum charge for an optional maintenance contract that entitles the customer to receive tangible personal property is taxable, even when such a contract is paired with a nontaxable electronic download or load-and-leave transaction.

The adoption of the proposed amendments to Regulation 1502 is not mandated by federal law or regulations. There is no previously adopted or amended federal regulation that is identical to Regulation 1502.

DOCUMENTS RELIED UPON

The Board relied upon Formal Issue Paper 13-007, the exhibits to the issue paper, and the comments made during the Board's discussion of the issue paper during its August 13, 2013, Business Taxes Committee meeting in deciding to propose the amendments to Regulation 1502 described above.

ALTERNATIVES CONSIDERED

The Board considered whether to begin the formal rulemaking process to adopt the proposed amendments to Regulation 1502 at this time or, alternatively, whether to take no action at this time. The Board decided to begin the formal rulemaking process to adopt the proposed

amendments to Regulation 1502 at this time because the Board determined that the proposed amendments are reasonably necessary for the reasons set forth above.

The Board did not reject any reasonable alternative to the proposed amendments to Regulation 1502 that would lessen any adverse impact the proposed action may have on small business or that would be less burdensome and equally effective in achieving the purposes of the proposed action. No reasonable alternative has been identified and brought to the Board's attention that would lessen any adverse impact the proposed action may have on small business, be more effective in carrying out the purposes for which the action is proposed, would be as effective and less burdensome to affected private persons than the proposed action, or would be more cost effective to affected private persons and equally effective in implementing the statutory policy or other provision of law than the proposed action.

INFORMATION REQUIRED BY GOVERNMENT CODE SECTION 11346.2, SUBDIVISION (b)(6) AND ECONOMIC IMPACT ANALYSIS REQUIRED BY GOVERNMENT CODE SECTION 11346.3, SUBDIVISION (b)

As previously explained, the proposed amendments to Regulation 1502, subdivision (f)(1)(C) and (D) clarify that, under existing law:

- A backup copy of a prewritten program recorded on tangible storage media may be included in a maintenance contract sold in connection with the sale or lease of the same or similar prewritten program;
- Tax still applies to 50 percent of the lump-sum charge for an optional maintenance contract that entitles the purchaser to receive tangible storage media, even if a backup copy of a prewritten program is recorded on the tangible storage media; and
- An optional maintenance contract, subject to tax at 50 percent of the lump-sum charge, may be appropriately paired with a separate nontaxable electronic download or load-and-leave transaction without changing the way tax applies to the electronic download or load-and-leave transaction.

Therefore, the proposed amendments do not change the taxation of prewritten programs or optional maintenance contracts under existing law.

Further, the proposed amendments to Regulation 1502 make it clear that software retailers may include backup copies of prewritten programs recorded on tangible storage media in their optional maintenance contracts, subject to tax at 50 percent of the lump-sum charge, and pair their taxable optional software maintenance contracts with separate nontaxable electronic download or load-and-leave transactions, or both. However, the proposed amendments do not require that software retailers include backup copies of prewritten programs recorded on tangible storage media in their optional maintenance contracts or pair taxable optional maintenance contracts with nontaxable download or load-and-leave transactions. Therefore, the proposed amendments do not impose any costs on software retailers.

Furthermore, the Board understands that, in 2013, software retailers generally sell or lease prewritten programs in nontaxable download or load-and-leave transactions. The Board

understands, based on Mr. Nebergall's comments discussed above, that it is not currently a common business practice for software retailers to provide a backup copy of a prewritten program recorded on tangible storage media to their customers as part of an optional maintenance contract. And, the Board only anticipates that some retailers will choose to include backup copies of prewritten programs recorded on tangible storage media in some of their optional maintenance contracts, subject to tax at 50 percent of the lump-sum charge, pair their taxable optional software maintenance contracts with some of their separate nontaxable electronic download or load-and-leave transactions, or both if there is a business reason for doing so. As a result, the proposed amendments to Regulation 1502 will not have a significant positive or negative effect on software retailers' current business practices, and the Board does not anticipate that software retailers will make significant changes to their current business practices solely due to the proposed clarifying amendments to Regulation 1502.

Therefore, based on these facts and all of the information in the rulemaking file, the Board has determined that the adoption of the proposed amendments to Regulation 1502 will neither create nor eliminate jobs in the State of California nor result in the elimination of existing businesses nor create or expand business in the State of California.

In addition, Regulation 1502 does not regulate the health and welfare of California residents, worker safety, or the state's environment. Therefore, the Board has also determined that the adoption of the proposed amendments to Regulation 1502 will not affect the health and welfare of California residents, worker safety, or the state's environment.

The forgoing information also provides the factual basis for the Board's initial determination that the adoption of the proposed amendments to Regulation 1502 will not have a significant adverse economic impact on business.

The proposed amendments to Regulation 1502 may affect small business.